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Discussion Paper: Accounting for Property and Liability Insurance Companies, November 26, 1975

American Institute of Certified Public Accountants. Auditing Standards Division

A DISCUSSION PAPER

Issued by the Auditing Standards Division
American Institute of Certified Public Accountants
for Public Comment

ACCOUNTING FOR PROPERTY AND LIABILITY INSURANCE COMPANIES

November 26, 1975

The purpose of this discussion paper is to solicit the views of interested parties, and the rationale supporting those views, on the questions discussed herein. No conclusions on these questions have been reached at this time by the Auditing Standards Division or any other division within the AICPA. The division will carefully consider all comments received before reaching its conclusions.

DISTRIBUTION OF DISCUSSION PAPER

This discussion paper has been distributed to the following interested groups:

- Practice Offices of CPA Firms
- Members of Council of the AICPA
- Members of Technical Executive Committees of the AICPA
- State Society Presidents and Executive Directors
- Chairmen of State Society Committees on Accounting Practices
- Chief Financial Officers of Property and Liability Insurance Companies

Copies are available to other interested persons and organizations on request.

WRITTEN COMMENTS ON DISCUSSION PAPER

Comments should be mailed, in time to be received by January 30, 1976, to

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AICPA INSURANCE AUDITING TASK FORCE DISCUSSION MEMORANDUM

ACCOUNTING FOR PROPERTY AND LIABILITY INSURANCE COMPANIES

PREFACE

This is a discussion memorandum on accounting for Property and Liability Insurance Companies prepared by the Insurance Auditing Task Force of the American Institute of Certified Public Accountants. The purpose of this memorandum is to obtain representative views on the appropriate accounting principles or methods to be applied in the following areas.

- Premium revenue recognition
- Deferred acquisition costs
- Premium deficiencies
- Losses
- Loss adjustment expenses
- Reinsurance
- Investment in real estate
- Other liabilities
- Valuation of investments and recognition of realized and unrealized gains or losses thereon
- Deferred income taxes

Your participation in this project will be greatly appreciated and your views will be considered by the Task Force in forming conclusions which will be set forth in a position paper on these subjects.

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ACCOUNTING FOR PROPERTY AND LIABILITY INSURANCE COMPANIES

The AICPA Insurance Auditing Task Force is in the process of revising the AICPA Industry Audit Guide, *Audits of Fire and Casualty Insurance Companies*. The Task Force has reviewed that section of the Guide dealing with variances between prescribed insurance accounting practices and generally accepted accounting principles and has attempted to identify areas in which existing practice varies, including areas in which further clarification of the Guide seems necessary, and certain areas which were not discussed in the Guide. Because of these variances, the Task Force intends to prepare a position paper to provide the FASB with a means for giving auditors guidance in forming opinions on financial statements of property and liability insurance companies prepared in conformity with generally accepted accounting principles.

This discussion memorandum has been prepared for the purpose of eliciting views from AICPA members, representatives of industry and other interested parties.

The views set forth herein are based on the knowledge of the Task Force members of existing practice and also on a limited exposure of the issues to the financial reporting committees of the American Academy of Actuaries, the American Insurance Association, and the Casualty Actuarial Society. *Many of the views or alternatives set forth herein are not at present generally accepted. Therefore, this discussion memorandum should not be considered as authoritative support for justifying a change in accounting methods.*

This discussion memorandum will be widely distributed in order to obtain a representative sample of the views on the issues set forth herein. The responses received, which will either confirm certain of the views expressed herein or will represent additional views, will be considered by the Task Force in reaching its conclusions.

This discussion memorandum is not intended to provide a basis for revising the industry Audit Guide, *Audits of Stock Life Insurance Companies*, particularly as it relates to health insurance. The Task Force believes that the Stock Life Insurance Guide as it relates to health insurance, should apply to property and liability insurance companies in addition to stock life insurance companies.

Areas in which regulatory practices differ from generally accepted accounting principles that have already been established by the present Audit Guide or an authoritative body designated by Council of the AICPA are discussed under the caption "Other Areas" in this memorandum.

PREMIUM REVENUE RECOGNITION

Premiums are generally collected as of the inception of the contract or installment period. Under regulatory accounting practices, such premiums are recognized as revenue evenly over the contract period, generally determined on a monthly or daily basis. This method, which was endorsed by the Audit Guide and has been generally accepted in the industry, will usually produce a proper association of premium revenues with losses and expenses that will be incurred over the contract period. However, some believe that a modification should be made to this basis of recognition where (a) the period of risk differs significantly from the contract period or (b) the incidence of risk, or the amount at risk, varies significantly during the contract period.

For the typical policy, the premium is fixed for the period of the contract. In most cases, that fixed amount is recognized over the contract period. However, for retrospectively rated and reporting-form policies, an estimated or deposit premium is collected which is adjusted at a subsequent date based on experience. In some cases, the deposit premium serves as a means of financing and, therefore, may only be a portion of the estimated premium. Under regulatory accounting practices, these premiums are usually accounted for in the following manner: (a) the original estimated or deposit premium is recognized evenly over the contract period with subsequent adjustments charged or credited to income as they occur, or (b) the ultimate premium is estimated and such ultimate premiums, which are revised during the contract period to reflect current experience, are recognized evenly over the period of the contract. The Audit Guide for Fire and Casualty Companies is silent on this subject and practice varies.

Those who favor (a) believe that the ultimate premium cannot be reasonably estimated and/or that estimating additional premiums which are not billable results in the anticipation of future income. Those who favor (b) believe that ultimate premiums can be reasonably estimated and believe that this method recognizes revenue as earned and produces a proper association of costs and revenues over the contract period.

Under regulatory accounting practices, additional premiums or return premiums on retrospectively rated and reporting-form policies are not treated uniformly as revenue or expense. In some cases, such amounts are charged or credited to revenue and in other cases certain amounts are charged or credited to revenue while some charges are made to expense, usually as dividends to policyholders. Some believe that a distinction should be made between premium refunds and those dividends which are a true sharing of profits and that the latter should continue to be treated as dividends by a charge to income immediately following predividend income. Others believe all adjustments to premiums, whether characterized as return premium or dividends, should be treated consistently by a charge to premium revenues.

DEFERRAL OF ACQUISITION COSTS

The AICPA Audit Guide for Fire and Casualty Insurance Companies discussed the accounting for costs incurred in connection with writing insurance and obtaining insurance premiums. The Guide indicates that regulatory accounting practices, which require such costs to be charged to income as they are incurred, do not produce a proper association of costs and revenues. Therefore, the Guide suggests that such costs be deferred and amortized over the contract period. This method has gained general acceptance in the industry.

The Audit Guide provides little guidance as to types of acquisition costs to be deferred. As a result, the Guide has been subject to differing interpretations which have resulted in variations in practices. The principal interpretations of the Guide are as follows:

(a) *Only those costs which vary directly with and are directly related to the production of business (new and renewal premiums written) should be deferred.* Those who support this view believe that such costs should generally be limited to commissions and premium taxes. In some circumstances, other nonlevel costs similar to commissions, which are incurred at the inception of the policy and for which a direct cause and effect relationship exists, should be deferred. They believe that all other costs should be associated with the current accounting period and that no useful purpose is served by allocating such costs among several accounting periods.

(b) *In addition to costs that vary directly, certain costs that vary indirectly and are directly related to the production of business should be deferred.* Those who support this view believe that certain underwriting costs that vary indirectly should be allocated among several accounting periods. Other underwriting costs that are fixed should be associated with the current period as suggested by those who support (a).

(c) *All costs related to the production of business should be deferred.* Those who support this view believe that all underwriting costs provide benefits to several accounting periods and should be allocated in a systematic and rational manner among such periods.

The Guide only describes one method for estimating deferred acquisition costs referred to as "equity in unearned premiums." Some suggest that this method can distort net income when the relationship of costs incurred to premiums written varies significantly from period to period. If deferred acquisition costs are estimated based on a percentage relationship of costs incurred to written premiums, they suggest that the percentage relationship once determined, except for any adjustment related to recoverability, should continue to be applied to the applicable unearned premiums throughout the term of such policies. Further, they suggest that acquisition costs should be amortized using more precise methods such as those used for amortizing premiums in order to more properly associate such costs with premium revenues.

PREMIUM DEFICIENCIES

The Fire and Casualty Audit Guide states that ". . . since the premium is expected to pay losses and expenses, and provide a margin of profit over the term of the policy, the portion measured by the unexpired term should be adequate to pay policy liabilities (principally losses and loss expenses) and return premiums during the unexpired term. . . ." Further, the Guide suggests that the premium should be adequate to recover any unamortized deferred acquisition costs. Paragraph 96 of FASB Statement No. 5 indicates that ". . . this statement does not prohibit (and, in fact, requires) accrual of a *net* loss (that is, a loss in excess of deferred premiums) that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated. . . ."

The Audit Guide does not discuss premium deficiencies but with respect to determining the limitation on acquisition costs to be deferred, the Audit Guide suggests that consideration be given to (i) the anticipated loss ratio, (ii) the anticipated loss expense ratio, and (iii) the anticipated ratio of expenses subsequent to acquisition. It further suggests that the determination of these anticipated ratios requires an analysis of historical data plus knowledge of other factors such as giving greater weight to the more recent loss experience taking into account recent rate changes which would be reflected in the unearned premiums in the balance sheet.

Premium deficiencies are determinable by (a) individual lines of business, (b) reasonable groupings of lines of business consistent with the company's manner of acquiring, servicing, and measuring profitability of its business, or (c) in the aggregate. Those who favor the determination of premium deficiencies based on individual lines or groupings ((a) and (b) above) believe that such lines or groupings should be self-sustaining and that profits in one line or grouping should not be used to offset losses in another. Those who believe that premium deficiency should be determined in the aggregate believe that this method is in conformity with risk theory. They suggest that the more diverse the insurance portfolio, the less is the risk of nonrecoverability in total.

Anticipated Expenses Subsequent to Acquisition

As stated above, the Audit Guide suggests that consideration should be given to anticipated expenses subsequent to acquisition. However, the Guide provides little guidance as to what types of expenses subsequent to acquisition should be considered. The Guide has been interpreted in the following manner:

(a) *Only anticipated losses, loss adjustment expenses and unamortized deferred acquisition costs directly related to policies in force should be considered in determining premium deficiency.* Those who support this view believe that, for purpose of determining premium deficiency, only variable expenses related to unearned premiums should be considered and that period costs should not be anticipated but should be charged to the period in which they are incurred. Further, they believe that, while certain other underwriting expenses or policy maintenance expenses may be attributable to policies in force at the end of an accounting period, they cannot be specifically identified.

(b) *In addition to anticipated losses, loss adjustment expenses and unamortized deferred acquisition costs, certain other underwriting expenses should be considered, provided that such costs may be attributed to maintaining the policies in force.* Those who support this view believe that such costs can be identified and should be anticipated.

(c) *Anticipated loss and loss adjustment expenses, together with all other underwriting expenses, should be considered in determining premium deficiency.* Those who support this view believe that the premium was intended to cover losses, loss expenses, and all other underwriting expenses. Therefore, consideration should be given to all such expenses in determining premium deficiency.

(d) *Anticipated policy dividends should also be considered in the above tests.*

Anticipated Investment Income

The Guide indicates that the recoverability of acquisition costs should be measured compared to underwriting results without regard to investment income. FASB Statement No. 5 is not specific with respect to how the determination of premium deficiencies should be made.

Some believe that investment income should be considered in the determination of any premium deficiency for the following reasons:

(a) The use of funds derived from the prepayment of premiums and the deferral of payment of anticipated losses and loss expenses on policies in force which give rise to investment income are considered in establishing premiums. Therefore, such investment income should be considered in determining any premium deficiency. However, some suggest that consideration should only be given to the use of funds derived from the prepayment of premiums.

(b) While investment income may not be considered in establishing premiums, such investment income should be considered as an integral part of determining whether a net loss (that is, a loss in excess of deferred premiums) will probably be incurred on insurance policies in force.

Others believe that investment income should not be considered in determining premium deficiencies for the following reasons:

(a) Underwriting results and investment income are separate and distinct functions and, therefore, should not be combined in determining premium deficiencies.

(b) While there is some theoretical justification for considering investment income in determining premium deficiencies, it is not practicable to allocate investment income to unearned premiums and losses on any reasonable basis.

(c) Because of the uncertainty inherent in establishing estimates of losses which will not be paid until some undetermined future date, investment income should merely be regarded as a margin for conservatism.

Finally, others believe that investment income should not be considered solely for the purpose of determining premium deficiencies but should be considered as a part of the question of stating liabilities for losses at their present value, as discussed later herein under the caption "Losses." Some who support this view believe that unearned premiums, liabilities for losses and loss adjustment expenses and deferred acquisition costs should be considered as a "unitary reserve" stated at present value.

Financial Statement Presentation

Some believe that, except in rare instances, future net losses cannot be any more reasonably estimated than can catastrophes. Therefore, they believe that the provisions of the Audit Guide and FASB Statement No. 5 have little, if any, applicability in practice.

Others believe that future net losses can be as reasonably estimated as can liabilities for incurred losses. Therefore, to comply with the Audit Guide and the requirements of FASB Statement No. 5, they suggest the following methods to provide for premium deficiencies:

(a) Any premium deficiency should first be recognized by writing off any unamortized deferred acquisition costs to the extent required. Should the premium deficiency be greater than the unamortized deferred acquisition costs, loss reserves should be provided for any additional deficiency. This method recognizes that an asset has been impaired and that such impairment should be recognized before any additional liabilities are created.

(b) Additional loss reserves should be provided for the full amount of the premium deficiency with no adjustment to deferred acquisition costs. This method is supported by the view that the original premium contemplated the acquisition costs and that the deficiency is caused by losses in excess of those anticipated at the time premiums were established.

(c) Unearned premiums should be increased by the amount of any premium deficiency. This method is supported by the view that the premium deficiency cannot be attributed to either the acquisition costs or additional losses.

Although the foregoing three methods all result in the same effect on net income, each method may produce significant variations in individual elements within the income statement and the resulting loss and expense ratios. Accordingly, others believe that a distinction whether a premium deficiency is related to excess acquisition costs, excess losses, or inadequate initial premiums is unnecessary and inappropriate. They believe that any additional liability and charges to income should be treated as a separate item in the financial statements, since such amounts are related to events of the next accounting period and they should not be permitted to distort the results of the current period without adequate disclosure.

LOSSES

Under regulatory accounting practices, losses are recognized as incurred. Estimated liabilities are established for losses that have been reported and additional estimates are made for losses that have been incurred but have not yet been reported to the company. This accounting method was endorsed by the Audit Guide, has been generally accepted by industry, and is reaffirmed in FASB Statement No. 5.

Regulatory practices do not permit liabilities to be reduced by estimated amounts of salvage and subrogation recoveries. However, the Audit Guide is silent on this matter. And practice also varies. Those who support the statutory method believe that this method is conservative and the recognition of salvage and subrogation in advance of collection would be anticipating future income. Those who believe that salvage and subrogation should be recognized believe that liabilities for unpaid losses should be based on the best estimate of the ultimate net cost of settlement. They believe that estimates of the ultimate net costs of settlement of claims should be based on past experience adjusted for current trends and other factors which would modify past experience and that the reduction for anticipated salvage and subrogation recoveries is an integral part of the estimating process.

Regulatory accounting practices permit liabilities for losses to be determined based on present value of future payments for those types of losses that are payable in fixed installments over a long period of time, such as workers' compensation claims and other forms of disability insurance. The Audit Guide is silent on this subject, and practice varies.

Some believe that liabilities for losses and loss adjustment expenses should not be stated at discounted value because underwriting and investment income should be maintained separately. Others believe that liabilities for losses and loss adjustment expenses should not be stated at discounted value but that investment income should be considered in determining premium deficiencies (see preceding section herein).

Those who believe that liabilities for losses and loss expenses should be stated at discounted value suggest that investment income, excluding investment income attributable to shareholders' (members') equity, is an integral part of insurance operations and present value concepts should be applied to all liabilities which are not expected to be settled in one year, *provided that the period for settling such losses can be reasonably determined.*

Others believe that present value concepts should only be applied to those types of losses that are payable in fixed installments over a long period of time, such as workers' compensation and other forms of disability insurance. Those who support this view believe that:

(a) Such liabilities are contractual obligations to pay money on fixed or determinable dates as contemplated in APB Opinion No. 21.

(b) Present value concepts should only be applied to these types of losses because it is not practicable to reasonably determine the period during which other types of losses will be paid or because of the uncertainty inherent in establishing estimates of losses which will not be paid until some undetermined future date.

LOSS ADJUSTMENT EXPENSES

Regulatory accounting methods provide that costs associated with the settlement of losses should be accrued in the period that the related losses were incurred. These costs include amounts paid for outside services and direct and indirect internal costs associated with the settlement of claims. No exception to this method was presented in the Audit Guide and this practice has been generally accepted in industry.

Those who support the regulatory practice believe that all costs associated with the settlement of losses should be accrued. They believe such costs should include amounts paid for outside services, internal costs, such as salaries and employee benefits of those employees involved in the settlement of losses and some or all such costs as rent, maintenance, telephone, and supplies, since such costs would be required to be incurred in order to settle losses, even in the event of liquidation.

Some believe that only those costs to be paid to outside adjusters or attorneys should be accrued. Others believe that, in addition to outside costs, the salaries and employee benefits of those company employees directly involved in the settlement of losses should be accrued. Both believe future fixed costs, such as rent, maintenance, telephone and supplies should not be associated with the accounting period prior to that in which they are incurred and, therefore, should not be accrued.

REINSURANCE

Under regulatory accounting practices, amounts recoverable from authorized and unauthorized reinsurers for recoveries related to unpaid losses and unearned premiums ceded are recognized in the financial statements as reductions of the related liability accounts. Amounts recoverable which are related to paid losses are treated as assets. The Audit Guide is silent on this subject and this practice has been accepted in the industry. However, some believe that all amounts recoverable from authorized and unauthorized reinsurers should be recognized in the financial statements as assets, subject to appropriate valuation allowances, rather than as offsets to liability accounts. They believe that generally accepted accounting principles do not permit offsetting amounts receivable against amounts payable to unrelated parties. Those who support the offsetting of such amounts believe that, in many instances, reinsurance is inextricably linked to the basic policy transaction. For example, commercial fire coverage may be provided in cases where an agent may either issue separate policies for two or more companies or may issue a single policy with agency reinsurance utilized to limit the primary carrier's risk to its stated retention. In either case, the net financial result is the same and form should not prevail over substance.

Under regulatory accounting practices, reinsurance premiums ceded are reported as a reduction of written and earned premium. The Audit Guide is silent on this subject and this practice has gained general acceptance in the industry. Some believe the purchase of catastrophe insurance coverage by a company is not a true sharing of risk and, therefore, the premiums should be treated as operating expenses as opposed to a reduction in written and earned premiums. Those who support the statutory method believe, as stated above, reinsurance is inextricably linked to the basic policy transaction and that a distinction cannot be made between a sharing of risk and the purchase of insurance.

INVESTMENT IN REAL ESTATE

Under regulatory accounting practices, real estate is classified as an investment regardless of its use. For real estate used in operations, rent is included in investment income and is charged to the operating departments. The Audit Guide is silent on this subject and it has gained general acceptance in the industry. Some believe that real estate should be classified either as an investment or as a fixed asset utilized in the business based on its predominant use. They also believe that depreciation and other real estate operating expenses should be classified under investment expenses or operating expenses in accordance with the classification of the related asset on the balance sheet and that imputed investment income and rent expense should not be attributed to real estate used in the business. Those who support the statutory method believe that failure to impute investment income and rent expense to real property is not in accordance with economic reality and may distort comparisons between companies who own and those who lease. They also believe that owning real estate used in operations is merely an alternative method of investing funds.

OTHER LIABILITIES

Under regulatory accounting practices, policyholder dividends are generally recorded as liabilities when declared by the board of directors. Some believe that such dividends should be provided on an accrual basis using best estimates of the amounts to be paid in order to associate such dividends with related premium revenues. Those who support the statutory method believe that, since the company is only legally liable for dividends declared, no additional liabilities are required.

Under regulatory accounting practices, contingent commissions are recognized in financial statements on either an accrual basis, a modified cash basis (i.e., accrual for commissions on expired contracts), or a cash basis. Some believe that contingent commissions should be accrued over the period during which the related premium revenue is recognized.

VALUATION OF INVESTMENTS AND RECOGNITION OF REALIZED AND UNREALIZED GAINS (LOSSES) THEREON

Under regulatory accounting practices, investments in common and preferred stocks are carried at market values and bonds are carried at amortized cost. Realized investment gains or losses are credited or charged to income. Changes in the carrying value of common and preferred stocks representing unrealized appreciation or depreciation are charged or credited to stockholders' equity. Those who support the regulatory method believe that:

(a) Carrying bonds, as to which there is no permanent impairment of value, at amortized value is appropriate since the investor who has the ability and intent to hold such investments to maturity will be able to realize face amount. Market values which merely reflect periodic changes in prevailing interest rates are irrelevant in valuing bonds which are expected to be held to maturity.

(b) Valuing common and preferred stocks at market is appropriate because an investor has no assurance that he will receive more or less than the current market value.

(c) The inclusion of realized gains and losses in net income is appropriate since it is based on the realization principle. Periodic fluctuations in market value are appropriately recognized in valuing investments, but should not be included in net income because they do not meet the realization principle. In addition, such amounts would frequently be so material as to make net income meaningless if they were included in the income statement.

Some who support the regulatory method also believe any write-down of an investment because of permanent impairment of value should be treated as a realized loss.

The Audit Guide endorses the regulatory basis for valuing investments. However, it suggests that realized and unrealized gains or losses should be combined in a separate statement. Those who support the separate statement approach believe that valuation of investments under the regulatory method is appropriate for the reasons stated above. However, changes in the value of such investments, whether realized or unrealized, should be presented in a separate financial statement as one combined amount. Such treatment is the most meaningful since the realization of a stock investment gain or loss has an exact opposite effect on the related unrealized gain or loss. Because of the materiality of such amounts and the significant fluctuations that occur, they should not be included in the determination of net income because they would make net income meaningless.

Other alternative methods for valuing investments and the treatment of realized and unrealized investment gains have been proposed. These methods are summarized below:

(a) Investments should be valued on the regulatory basis and realized and unrealized investment gains or losses should be combined and included in the determination of net income. Such treatment is consistent with the concept of APB Opinions Nos. 9 and 20 which required all items of profit or loss, except prior period adjustments and certain accounting changes, to be recognized during the current period.

(b) Investments should be valued on the regulatory basis and realized and unrealized investment gains or losses should be included in income on some averaging or yield method. Such treatment recognizes the economic reality that investments are made to produce fixed income and appreciation of value, both of which are an integral part of the anticipated yield.

(c) Investments should be carried at cost and only realized gains should be reflected in income. It is appropriate to carry income producing assets, including investments, at cost. Occasional dispositions of investments to improve overall investment yields or to meet other periodic investment philosophies is not sufficient reason for departing from the historic cost basis. Gains or losses should only be recognized in income when realized by sale or other disposition, or, in the case of losses, when such sale or disposition is imminent.

INCOME TAXES

Under regulatory accounting practices, provision is made only for income taxes currently payable. The Audit Guide indicated that deferred income taxes should be provided on timing differences, principally the increase or decrease in deferred acquisition costs and on unrealized investment gains. The Guide was issued before APB Opinion No. 11 became effective. Therefore, it is silent on comprehensive income tax allocation. Some believe certain unique characteristics in the financial reporting of property and liability insurers must be considered in applying comprehensive income tax allocation contemplated by APB 11. These areas and the suggested alternative accounting treatments are as follows:

(a) The treatment of the tax effects of capital loss carryforwards when only realized investment gains or losses are included in the determination of net income.

(i) Record the tax benefit in shareholders' (members') equity of capital loss carryforwards as a reduction of deferred income taxes on unrealized investment gains.

(ii) Record no tax benefit from capital loss carryforwards, but disclose their existence, the date of expiration and the amount thereof.

(b) The treatment of book operating loss carryforwards remaining after elimination of deferred income credits in accordance with paragraph 48 of APB Opinion No. 11.

(i) Record the benefit in shareholders' (members') equity of book operating loss carryforwards as a reduction of deferred income taxes relating to unrealized investment gains.

(ii) Record no tax benefit in shareholders' (members') equity of operating loss carryforwards as a reduction of deferred income taxes applicable to unrealized investment gains, but disclose their existence, the date of expiration and the amount thereof.

(c) Operating losses used to offset realized investment gains when only realized investment gains are included in the determination of net income.

(i) The tax provision for the realized investment gains and the related tax benefit for the operating losses should be determined at the tax rates applicable to ordinary income, as opposed to the use of capital gains rates, in the same manner as intraperiod tax allocations are applied to extraordinary items.

(ii) Taxes on capital gains should always be calculated at capital gains rates.

(d) Treatment of deferred tax benefits relating to unrealized losses on common and preferred stocks.

(i) Deferred tax benefits relating to unrealized losses on common and preferred stocks should be recognized in shareholders' (members') equity to the extent of deferred taxes previously provided on unrealized gains, and the tax benefit of any excess unrealized losses may be recognized to the extent of actual taxes paid on realized gains which are still available for recovery through carryback of loss.

(ii) Deferred income tax benefits relating to unrealized losses on common and preferred stocks should be recognized only to the extent of the deferred taxes previously provided on unrealized gains. No portion of unrealized capital losses should be carried back to reduce actual taxes paid on realized gains unless the realization of such losses are assured beyond a reasonable doubt, in which case the loss and related tax benefit should be recorded as a realized loss.

(e) The treatment of deferred income taxes applicable to accretion of bond discount.

(i) Deferred income taxes applicable to bond discount should be provided at capital gains rates because such amounts represent a difference in the timing of recognition of a capital gain.

(ii) Deferred income taxes applicable to bond discount should be calculated using ordinary income rates because, if an election was made to include such amounts in taxable income, they would be treated as ordinary income.

OTHER AREAS

Certain accounting practices described in the audit guide or for which accounting principles have otherwise been established are not included in this discussion memorandum because, in the view of the task force, those practices do not require reconsideration or clarification. The views of respondents who choose to comment on those practices will, however, be studied by the task force. These would include, for example,

(i) Investments in unconsolidated subsidiaries and affiliates.

(ii) Liability for unauthorized reinsurance.

(iii) Nonadmitted assets.